OFFICE OF THE SECRETARY OF THE TREASURY
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MEMORANDUM FOR THE VICE PRESIDENT
THE SECRETARY OF STATE
THE SECRETARY OF DEFENSE
THE SECRETARY OF AGRICULTURE
THE SECRETARY OF COMMERCE
THE SECRETARY OF THE INTERIOR
THE SECRETARY OF ENERGY
THE DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
CHAIRMAN, COUNCIL OF ECONOMIC ADVISORS
ASSISTANT TO THE PRESIDENT FOR NATIONAL SECURITY AFFAIRS
ASSISTANT TO THE PRESIDENT FOR POLICY DEVELOPMENT
UNITED STATES TRADE REPRESENTATIVE
DIRECTOR OF CENTRAL INTELLIGENCE

SUBJECT: Senior Interdepartmental Group on International Economic Policy (SIG-IEP)

Attached are background papers on oil prices and the U.S.-Japan Energy Working Group for the meeting of the SIG-IEP scheduled for Thursday, February 3, at 3:00 p.m., in the Roosevelt Room. The Summit update will be an oral report; papers on the Coffee Agreement were circulated January 25. Butter exports has been taken off the agenda.

Also attached are the minutes for the January 20 and 27 meetings of the SIG-IEP.

Attendance is principal, plus one. Please phone the names of your representatives to Ms. Kennedy at 566-2404.

David E. Pickford
David E. Pickford
Executive Secretary

Attachments

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Decline in Oil Prices

In view of the current softness of oil prices and the possibility of a price fall in the near-term -- moderate, $2-5/bbl; large, $10-15/bbl; or something in between -- the USG needs to consider:

-- what position to take now on the desirability of a sharp break in oil prices;

-- whether it should (or could) do anything to make such a fall more or less likely; and

-- if it happens, whether tax policy should be used to obtain either national security, energy policy, or revenue objectives.

Areas for consideration include the impact on the domestic oil industry and development of alternative forms of energy, assurance of stability in the domestic banking and international financial systems, and achievement of domestic and international energy policy objectives.

The principal short-term implications of a 40 percent drop in the average price of oil are:

-- Additions to real economic growth during each of the two years following the price cut of 1% to 1.5% for the U.S. and other industrial countries, and of 2% to 2-1/2% for the non-oil LDC's. (Effects among specific economic sectors and industries would differ. Likely gainers include chemicals, steel and transportation, while primary energy producers and related service industries might lose.)

-- A reduction in U.S. inflation of 1.5-2.0%, reaching perhaps 2.5% after two years. (The experience in other non-oil countries would be similar.)

-- A reduction in industrial countries' oil import bill of $90-100 billion in the first year following the cut (down by $20 billion in the U.S. alone). This would contribute in the OECD to a swing in the projected current account from about -$10 billion deficit to about +$17 billion surplus.

-- However, Norway and the U.K. rely to an increasing degree on oil exports revenues. If prices drop 40%, direct annual revenue losses could reach 1.5% and 5% of GNP for the U.K. and Norway, respectively. Exchange rate changes could, to some degree, offset these losses. Canada's oil trade is essentially in balance, but the price drop would cut deeply into federal revenues.

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-- The LDCs would save about $9 billion on their total oil bill and enjoy a 3% real increase in exports. As a result, their total current account deficit would decline by about $18 billion. Of the ten largest LDC debtors to commercial banks, only Mexico and Venezuela (as oil exporters) would face worsening debt problems. (Mexico could lose roughly $6.5 billion on an annual basis; Venezuela, about $7 billion.) For 1983, this loss would be less since any price drop would come during the year. However, both countries would be likely to resist strongly defaulting on loans and have some scope to increase oil export volumes, in part offsetting the price drop. Clearly more adjustment and a greater amount of rescheduling would be necessary though.

-- As a group, OPEC countries would lose about $100 billion in revenues. A drop of this magnitude would likely be split evenly between drawing down foreign exchange reserves and reducing imports.

-- Some banks would be in the uncomfortable position of "being forced" to increase their exposure in such countries as Mexico and Venezuela, but could not expect a corresponding increase in interest earnings. Thus, there would likely be more net lending with explicit rescheduling to these countries. However, while banks would see the quality of some outstanding loans reduced, the quality of other loans would be improved (e.g., to Brazil or Korea).

These are very preliminary judgments, and more detailed analyses are under way on such questions as the effects on exchange rates, interest rates, the structure of international payments, and Mexico (as the primary example of a loser). Particular attention is being paid to the question of whether a large oil price decline would be sustainable or would merely accelerate the onset of energy security problems now foreseen as probable for the late 1980's by the International Energy Agency. In addition, more detailed analyses of the consequences for particular countries, including more detailed foreign relations aspects, are being conducted.

It is quite possible that a $10-15/bbl oil price drop would be unsustainable and ensuing market instability might quickly lead to renewed OPEC control over prices -- suggesting, <u>inter alia</u>, that tax policy might be useful here to offset such a price decline and subsequent OPEC reformation. However, abandonment of reliance on the market, on the grounds that the USG "knows better" than the market, could make matters worse -- and actually aid the OPEC in its market control objectives. In this regard, reference was made to our 1974-75 decision to opt for oil price controls -- with attendant delay in adjusting the U.S. economy to world oil prices.

On the basis of the analysis contained in the papers considered by the IG, any fall in oil prices is to be welcomed.

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